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In the Supreme Court of the United States

OCTOBER TERM, 1985

WILLIAM C. RANDALL, ET AL., PETITIONERS

v.

B.J. LOFTSGAARDEN, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE UNITED STATES AND THE SECURITIES AND EXCHANGE COMMISSION AS AMICI CURIAE IN SUPPORT OF PETITIONERS

CHARLES FRIED
Solicitor General

ROGER M. OLSEN
Acting Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

ALBERT G. LAUBER, JR.
Assistant to the Solicitor General

ANN BELANGER DURNEY
TERESA E. MCLAUGHLIN
Attorneys

Department of Justice
Washington, D.C. 20530
(202) 633-2217

DANIEL L. GOELZER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

RICHARD A. KIRBY
Assistant General Counsel

MARTHA H. MCNEELY
CATHERINE T. DIXON
Attorneys
Securities and Exchange Commission
Washington, D.C. 20549

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QUESTION PRESENTED

Whether, in an action under the federal securities laws for fraud committed in the sale of a security in the form of a tax-shelter investment, the defendant is entitled to reduce the amount of the plaintiff's recovery by tax benefits allegedly realized by the plaintiff on account of that investment.

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INTEREST OF AMICI CURIAE

The Securities and Exchange Commission is responsible for administering and enforcing the federal securities laws. A major purpose of those laws is to protect investors from fraudulent practices by promoters in the offer and sale of securities. Although most tax-shelter securities are sold in private offerings exempt from the registration requirements of the Securities Act of 1933, they are subject to the antifraud provisions both of that Act and of the Securities Exchange Act of 1934.

In a recent year, about two-thirds of the 15,000 private offerings made under SEC Regulation D, 17 C.F.R. 230.501 *et seq.*, were limited-partnership, and thus presumably tax-shelter, ventures. SEC Directorate of Economic and Policy Analysis, *An Analysis of Regulation D*, at i-ii (May 1984). Given this volume of offerings, the SEC lacks the resources to ensure that fraud in the offer or sale of tax-shelter investments will be detected and

prosecuted. Private damage actions under the federal securities laws are thus a necessary supplement to the Commission's enforcement activities. *Bateman Eichler, Hill Richards, Inc.* v. *Berner*, No. 84-679 (June 11, 1985), slip op. 10, 16-18.

The tax-offset rule adopted by the court of appeals contravenes the policies and purposes of both the securities laws and the tax laws. It undermines the deterrent purposes of private securities actions by allowing a defrauding seller to retain proceeds that he has illegally obtained from his victim, and may often deter the victim from bringing suit at all. And its effect is to make the government, the source of the buyer's tax benefits, subsidize the seller's fraud, thus granting a windfall to the wrongdoer at the expense of taxpayers generally. At this Court's invitation, the United States filed a brief in *Salcer* v. *Envicon Equities Corp.*, petition for cert. pending, No. 84-1447, urging that certiorari be granted in the present case.

STATEMENT

1. Petitioners are purchasers of interests in a real estate limited partnership organized to construct, own and operate a Ramada Inn in Rochester, Minnesota (Pet. App. A3). Respondents are the promoter of the project and three of his closely-held corporations. One of the corporations owned the land on which the hotel was to be built, another served as the general contractor, the third as general partner (*id.* at D1-D4).

The partnership was marketed as a "tax shelter." Its offering memorandum represented that the limited partners would realize income tax savings as a result of losses expected to be incurred during the partnership's first three years, and that the limited partners would thereafter share in the venture's expected profits (Pet. App. A3). Petitioners purchased their interests in 1973 at a cost of $35,000 per unit (*id.* at D1, D7 n.8).

The Ramada Inn opened in 1974, several months behind schedule, and at a construction cost substantially in excess of that projected (Pet. App. A3). The hotel subse-

quently incurred sizable losses due to higher-than-budgeted operating expenses and lower-than-predicted occupancy rates (*id.* at D9). The partnership ultimately defaulted on its obligations, and foreclosure by its creditors ensued in 1978 (*id.* at A3, D10).

In June 1976, petitioners brought this securities fraud action in the United States District Court for the District of Minnesota, seeking recovery under Section 12(2) of the Securities Act of 1933, 15 U.S.C. 77*l*(2), Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and SEC Rule 10b-5, 17 C.F.R. 240.10b-5. After a seven-day trial, the jury found that respondents had violated Section 10(b) and Rule 10b-5 by knowingly making material misrepresentations and omissions in the offering memorandum upon which petitioners had relied, thereby causing injury to petitioners. The jury also rendered an advisory verdict, adopted by the district court, finding that respondents were likewise liable for their fraud under Section 12(2) (Pet. App. A4).

The district court found that petitioners' investments had become worthless by the time they learned of the fraud (Pet. App. E15). It awarded them rescissionary damages under Section 12(2) in the amount of the purchase price that each had originally paid, plus prejudgment interest (*id.* at E15, E16, F15). The court noted (*id.* at E16) that petitioners' Section 10(b) claim "independently support[ed]" a grant of relief, but that their recovery under Section 10(b) would be no greater than under Section 12(2). The court rejected, as "sophistic malarkey," respondents' contention that petitioners' damages should be reduced by the amount of tax benefits that they had assertedly received (*id.* at F8).

2. The court of appeals sustained the district court's determination that respondents were liable under Sections 10(b) and 12(2) (Pet. App. D11-D18). It concluded that "misrepresentations so permeated" the offering memorandum as to render the memorandum's forecasts and projections unreasonable and misleading (*id.* at D5, D14). The court of appeals also upheld the jury's

finding that respondent Loftsgaarden had understated by more than 50% the compensation that his closely-held corporations were to receive for their roles in the venture (*id.* at D9).

The court of appeals reversed the district court's award of damages, however, and remanded for a new trial on that issue (Pet. App. D20-D28). It held that petitioners' recovery, under either Section 10(b) or Section 12(2), had to be reduced by the amount of any tax benefits that their investment had generated. The court noted (Pet. App. D20) that a plaintiff's recovery under Section 10(b) cannot be "in excess of his actual damages on account of the act complained of" (15 U.S.C. 78bb(a)). "The actual damages principle," the court said, "requires that a rescissional or restitutional award be reduced by any value received as a result of the fraudulent transaction," and the court concluded that petitioners' tax deductions constituted "value received as a result of" their tax-shelter investment (Pet. App. D21 (original quotation marks omitted)). The court of appeals further noted (*id.* at D21-D22) that Section 12(2) permits a defrauded investor "to recover the consideration paid for [the] security with interest thereon, less the amount of any income received thereon" (15 U.S.C. 77*l*(2)). Since petitioners' tax deductions served to reduce their taxable income, the court reasoned, those deductions were essentially the equivalent of "income received."

Noting that petitioners' tax returns for 1973-1978 were then "undergoing audits by the Internal Revenue Service," the court of appeals acknowledged that the damages formula it mandated was not "entirely devoid of speculation" (Pet. App. D27). "[T]he possibility that past tax deductions will be disallowed," the court said, was "[c]ertainly * * * relevant to the determination" of petitioners' damages (*ibid.*). The court ruled that "[e]vidence of the audit and expert opinions as to its likely results [should be] admissible at the retrial on damages," with "[t]he jury [being] entitled to determine whether and to what extent there would be a disallowance of deductions" (*ibid.*).

3. On remand, the district court accepted respondents' calculation of petitioners' tax benefits (Pet. App. C2-C4). These calculations were based on petitioners' federal and state income tax returns for 1973-1978, and on a report prepared by an IRS revenue agent, upon conclusion of the audit, reflecting petitioners' agreement to recognize a certain amount of income as a result of the hotel's foreclosure in 1978 (C.A. App. A138, A153-A154). The district court then calculated each petitioner's damages as the amount he had paid for his investment, plus 8% simple interest from the date of his purchase, minus the amount of his net tax benefits (Pet. App. B1-B3).

4. On cross-appeals from the district court's judgment, the court of appeals ordered reconsideration en banc. As to the propriety of the tax-offset rule, the court adhered to the original panel opinion. It held that the receipt of tax benefits negates pro tanto a plaintiff's "actual damages," and it held that the "actual damages" limitation applicable to recoveries under Section 10(b) of the 1934 Act likewise applies to computations of restitutionary awards under Section 12(2) of the 1933 Act (Pet. App. A6-A8). While acknowledging that tax benefits are not "a form of income in a strict accounting sense," the court expressed the view that "section 12(2)'s requirement that 'income received' be deducted in determining rescissionary damages simply reflect[s] that all economic benefits bargained for and received must be deducted" in computing damages (Pet. App. A11 (footnote omitted)). The court accordingly held that the words "income received" as used in Section 12(2) "should be construed as including the tax benefits bargained for and received in the special case of a tax shelter investment" (Pet. App. A8).

The court then adopted an elaborate formula for computing recoveries under Section 12(2) in light of the tax-offset rule. It began by accepting the district court's calculation of the "permanent tax benefits" that each petitioner had received (Pet. App. A15). It agreed with the district court that petitioners were entitled to prejudg-

ment interest on their rescinded investment, but reasoned that, "[b]ecause [they] were not deprived of the use of the entire amount of their investments over the ten year period, prejudgment interest is due only on the amount of money they were out-of-pocket at any given time" (*id.* at A20). The court hence subtracted from petitioners' original investment the tax benefits that they had received each year, and then calculated prejudgment interest based on that annually-declining balance (*id.* at A21). For years in which petitioners' cumulative tax benefits exceeded their original investment, petitioners in effect were required to pay prejudgment interest to respondents (*ibid.*).

The court next held that it was necessary to take into account, not only the tax savings that petitioners had previously enjoyed, but also the tax consequences of any securities-fraud recovery that they might receive herein. The court "assume[d] that each [petitioner was] still in the fifty percent tax bracket," and it assumed that each petitioner's recovery would be taxed to him in full as ordinary income rather than as capital gains (Pet. App. A22). Concluding that each petitioner therefore "must receive twice the [previously-computed] damages and net interest cost" in order to make his after-tax recovery equal to his "actual damages," the court doubled the figure previously computed (*ibid.*). The court of appeals held, in other words, that the measure of rescissionary damages prescribed by Section 12(2) is the plaintiff's original investment, minus his tax benefits, plus prejudgment interest on his original investment, minus prejudgment interest on his tax benefits, times two (*ibid.*).[1]

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[1] The result of applying the tax-offset rule was to reduce considerably each petitioner's damages award compared to what it would otherwise have been. For example, apart from any consideration of tax benefits, petitioner Randall under the district court's computation would have been entitled to a total recovery of $67,973 (Pet. App. B1-B2). Under the court of appeals' holding Randall's recovery was $506 (*id.* at A22). Petitioner Neumann's recovery was simi-

Chief Judge Lay, joined by Judge Bright, dissented (Pet. App. A25-A30). They contended that the majority's treatment of tax benefits as "income received" for purposes of Section 12(2) conflicted with "the clear language of the statute" (Pet. App. A26-A27). They argued that a plaintiff's alleged tax benefits should have no role in determining his securities-fraud recovery, since "[t]he tax transaction is between [the plaintiff] and the government and should not affect [the defendant's] liability" (*id.* at A29). And they argued that the majority's tax-offset rule improperly allows a defendant "to escape liability, shifting the burden of the loss onto the government" (*id.* at A30).

SUMMARY OF ARGUMENT

The court of appeals' decision is wrong as a matter of securities law, tax law and common sense. The tax-offset rule cannot be squared with the language of Section 12(2), which permits a rescinding buyer to recover the consideration paid for his security, "less the amount of any income received thereon." Tax deductions and credits provided by the Internal Revenue Code are not "income received * * * on" a partnership investment.

This plain-language reading is confirmed by principles governing the common-law remedies of rescission and restitution, which Section 12(2) codifies. The common law required the rescinding buyer to restore to the seller the contested property plus its "direct product," that is, those benefits derived immediately from the property without the intervention of any independent act by the buyer. Because tax deductions and credits are derived from the Internal Revenue Code, not from the investment property, and because they require independent acts of the taxpayer (including generation of income) before they can come into existence, they are not a "direct product" of

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larly reduced from $96,385 to $1,984; petitioner Austin's from $64,610 to $7,666; and petitioner Anderson's from $64,787 to $18,790. Compare *id.* at B1-B2 with *id.* at A22.

the rescinded investment requiring "restoration" to the fraudulent seller.

In adopting its tax-offset rule, the court of appeals also took an unduly narrow view of the "actual damages" principle as applied to recoveries under Section 10(b). That principle permits a plaintiff to recover an amount in excess of his actual economic loss where necessary to prevent the defendant's unjust enrichment. If a plaintiff were ultimately to realize any net tax benefits from the rescinded transaction, it would unjustly enrich the defendant to transfer those savings to him via the tax-offset rule. As between the investor and the promoter who defrauded him, the investor is plainly more equitably situated to retain this species of publicly-funded largesse, not only because he is the victim rather than the perpetrator of fraud, but also because he is the person upon whom Congress conferred the tax benefits to begin with.

The tax-offset rule is also wrong as a matter of tax law. In appraising a plaintiff's aggregate tax benefits, one must consider, not only the tax benefits previously claimed, but also the tax consequences of his securities-fraud recovery. The Internal Revenue Code has intricate mechanisms that require the offset or "recapture" of previously-claimed tax benefits upon receipt of a damages award. This Court accordingly held in *Hanover Shoe, Inc.* v. *United Shoe Machinery Co.*, 392 U.S. 481 (1968), that an award of damages must be based on the plaintiff's *pre-tax* loss where the award itself will be taxed. The rationale of that decision applies equally here.

Finally, the tax-offset rule would seriously compromise the deterrent value of private actions in enforcing the securities laws. In reducing or eliminating the damages recoverable by plaintiffs defrauded in tax-shelter schemes, it would lessen the incentives for promoters to comply with the law by permitting wrongdoers to retain the fruits of their fraud.

ARGUMENT

WHERE A DEFRAUDED PURCHASER OBTAINS RESCISSION OF HIS SECURITIES TRANSACTION UNDER THE FEDERAL SECURITIES LAWS, THE DEFENDANT'S LIABILITY SHOULD NOT BE REDUCED BY THE TAX SAVINGS, IF ANY, REALIZED BY THE PURCHASER ON ACCOUNT OF HIS OWNERSHIP OF THE SECURITY

A. At Common Law, The Restitutionary Recovery Of A Rescinding Purchaser Would Not Be Reduced By His Tax Savings

In deciding what remedies are proper under the federal securities laws, it is often appropriate to begin by considering "the state of the law at the time the legislation was enacted" in order to ascertain "Congress' perception of the law that it was shaping or reshaping." See *Merrill Lynch, Pierce, Fenner & Smith* v. *Curran*, 456 U.S. 353, 378 (1982). It is useful here, in determining the proper measure of restitutionary recovery in actions under Sections 10(b) and 12(2), to start by examining the common-law doctrines of rescission and restitution as applied by the courts contemporaneously with those statutes' enactment. Examination of these doctrines shows that the rationale underlying the court of appeals' tax-offset rule is contrary to the common law.

At common law, a person induced by a false prospectus, report or other promotional document to buy stock could sue the seller for rescission of the transaction and restitution of the consideration paid. See, *e.g.*, *Seneca Wire & Mfg. Co.* v. *A.B. Leach & Co.*, 247 N.Y. 1, 159 N.E. 700 (1928); *Hall* v. *Bank of Baldwin*, 143 Wis. 303, 127 N.W. 1969 (1910); 3 J. Pomeroy, *A Treatise on Equity Jurisprudence* § 881 (5th ed. 1941). Rescission was the act of voiding the original transaction. Restitution implemented the return of property to each party in order to restore, as nearly as possible, the status quo ante. See C. McCormick, *Handbook on the Law of Damages* § 121, at 448 (1935); D. Dobbs, *Handbook on the Law of Remedies* § 4.1 (1973).

Under principles of common-law restitution, the seller was required to surrender the consideration that he had received from the rescinding buyer, together with interest thereon. See Restatement of Restitution §§ 28, 151, 156 (1937); 3 H. Black, *A Treatise on the Rescission of Contracts and Cancellation of Written Instruments* § 632 (2d ed. 1929). In exchange for the return of his consideration, the buyer was required to relinquish the property that he had received from the seller, together with any earnings on that property.[2] If the buyer had sold the security before bringing suit, he could obtain a money judgment approximating his purchase price, plus interest, minus the proceeds of his sale and minus any income that he had earned on the security while he owned it.[3]

In calculating a restitutionary award at common law, the courts uniformly held that the "earnings" with which the defendant was to be credited were those that represented the "direct product" of the buyer's security ownership, such as dividends received on corporate stock or interest paid on corporate bonds. Restatement of Restitution §§ 157, 205 (1937). According to the Restatement (*id.* § 157 comment *b*):

> The phrase "direct product" means that which is derived from the ownership or possession of the property without the intervention of an independent transaction by the possessor.

Credit to the seller, in other words, was limited to return of the property itself (including, in certain circumstances, compensation for depreciation in its value), plus any benefits conferred directly upon the purchaser

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[2] Restatement of Restitution §§ 1, 65, 157(1)(a) (1937); G. Clark, *Equity* 445 (1954); 3 H. Black, *supra*, § 617, at 1495 (citing cases); 2 J. Story, *Equity Jurisprudence* §§ 936-938, 962-966 (1918); 5C A. Jacobs, *Litigation and Practice Under Rule 10b-5*, ¶ 260.03[c][vi], at 11-56 (2d ed. 1985) (discussing common-law doctrines).

[3] Restatement of Restitution §§ 4(f), 66, 150, 157 (1937); D. Dobbs, *supra*, § 9.4, at 622-628. See 2 J. Story, *supra*, §§ 963-965.

by the property (such as income generated by it or the fair market value of its use).[4] It thus followed that a defrauded purchaser at common law was entitled to retain any benefits that originated from a source independent both of the property and of the seller. For example, if a dentist had rendered services at his premises, and if his purchase of that realty were later rescinded, he would not have been required at common law to "restore" to the seller any portion of the fees received for his labor. Those benefits, while related in a way to the property, would obviously not represent the direct and immediate product of its ownership.

The common-law doctrines of rescission and restitution had strong roots in equity. Inherent in the restitutionary remedy was the prevention of either party's unjust enrichment by his retention of property belonging to the other.[5] Where necessary to prevent a wrongdoer's unjust enrichment, moreover, restitution permitted a plaintiff to recover an amount that exceeded his actual economic loss.[6] As between the wrongdoer and his victim, any doubt concerning entitlement to the benefits of a

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[4] See 1 G. Palmer, *The Law of Restitution* §§ 3.12 to 3.14 (1978); 3 H. Black, *supra*, §§ 633-634; Restatement of Restitution § 157 comment *b* (1937) (upon rescinded purchase of realty, seller is entitled to credit for buyer's interim use and occupancy, including rents and compensation for diminution in value). Accord, *e.g.*, *Dieterich* v. *Rice*, 124 Wash. 613, 215 P. 65 (1923) (deduction from buyer's restitutionary award of property's reasonable rental value); *Wright* v. *Dickinson*, 67 Mich. 580, 35 N.W. 164 (1887) (same, value of timber cut from property).

[5] See Restatement of Restitution §§ 1 & comment *e*, 3, 28(c) (1937); 3 J. Pomeroy, *supra*, § 873; D. Dobbs, *supra*, § 4.1, at 224-229; Thompson, *The Measure of Recovery Under Rule 10b-5: A Restitution Alternative to Tort Damages*, 37 Vand. L. Rev. 349, 365-367 (1984) (discussing common-law doctrines); Seavey & Scott, *Restitution*, 54 Law Q. Rev. 29, 29-31 (1938).

[6] Restatement of Restitution § 1 & comment *e* (1937); D. Dobbs, *supra*, at 224, 243-244, 629; Seavey & Scott, *supra*, at 37.

rescinded transaction was resolved at common law in favor of the defrauded party.[7]

These principles of restitution had a counterpart in the common-law tort doctrine generally known as the "collateral sources" rule. Under that rule, a wrongdoer's liability to pay damages was not reduced on account of "[p]ayments made to or benefits conferred on the injured party from other sources," even where such collateral payments "cover[ed] all or part of the harm for which the tortfeasor [was] liable." Restatement (Second) of Torts § 920A(2) & Reporter's Note (1979). See Restatement of Torts §§ 920 comment *e*, 924 comment *c* (1939); D. Dobbs, *supra*, § 8.10. The "collateral sources" doctrine applied, not only in computing recoveries against tortfeasors, but also in calculating certain contract damages, particularly where there had been a fraudulent breach. See *id.* at 185; Fleming, *The Collateral Source Rule and Contract Damages*, 71 Cal. L. Rev. 56, 64 (1983). The doctrine was justified on the ground that "a benefit that is directed to the injured party should not be shifted so as to become a windfall for the tortfeasor," at least where the benefit "did not come from the defendant or a person acting for him." Restatement (Second) of Torts § 920A(2) comment *b* (1979). Like the unjust-enrichment aspects of common-law restitution, the "collateral sources" rule was rooted in principles of fairness. It might in certain situations "permit a double recovery, but it [did] not impose a double burden. The tortfeasor [bore] only the single burden for his

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[7] *E.g.*, *Falk* v. *Hoffman*, 233 N.Y. 199, 135 N.E. 243 (1922) (Cardozo, J.) (defrauded seller of stock permitted to recover not merely the difference between the value of the stock and the amount paid by the defendants, but the proceeds of resale even if such proceeds exceeded its value). See Restatement of Restitution § 3 (1937) ("A person is not permitted to profit by his own wrong at the expense of another."); *id.* §§ 66 & comment *b*, 142 (depreciation in value of property, as between innocent buyer and fraudulent seller, need not be restored to seller); D. Dobbs, *supra*, § 9.4, at 923-925, 928.

wrong." *Gypsum Carrier, Inc.* v. *Handelsman*, 307 F.2d 525, 534 (9th Cir. 1982).

2. The doctrines discussed above, which were current at the time the federal securities laws were enacted, make it clear that a defendant in respondents' position could not have eliminated or reduced, by reference to his victim's tax savings, his liability for fraud at common law. In the language of restitution, such tax savings would not have been deemed the "direct product" of the investment fairly creditable to the defendant's account. Entitlement to tax deductions and credits is conferred, not by the property itself or by its promoter, but by the federal government through the Internal Revenue Code. Since tax benefits do not emanate from the seller or from the property, and since the seller under the tax laws has no claim to these benefits, it makes little sense to say that they should be "restored" to him upon rescission of the transaction.

Moreover, even if tax benefits were thought in some sense to be "derived from the [plaintiff's] ownership or possession of the property," they are not a "direct product" of the investment because they require "the intervention of an independent transaction by the possessor" before they can come into existence. Restatement of Restitution § 157 comment *b* (1937). The right to tax deductions in and of itself has no economic value. What makes tax deductions beneficial is the investor's independent generation of income through his own labor or capital, which in turn enables him to take advantage of deductions made available by the tax-shelter venture. The investor himself in another respect also plays a significant role in generating the tax deductions claimed, since it is his capital contributions, together with those of his co-investors, that give rise to the venture in the first place. While the promoter may have rendered services in connection with the partnership, those services play only a partial and indirect role in securing the plaintiff's tax savings. For all these reasons, a buyer's tax savings would not have been viewed as a "direct product" of his

rescinded investment requiring restoration to the defrauding seller at common law.

The "collateral sources" rule at common law would have yielded the same result. Benefits are deemed "collateral" under that rule depending on their character and purpose. See *Haughton* v. *Blackships, Inc.*, 462 F.2d 788, 790-791 (5th Cir. 1972). The tax benefits at issue here were conferred upon investors by Congress for the purpose of stimulating certain kinds of real estate activity deemed socially desirable. The fraudulent promoter, being the mere incidental beneficiary of Congress's largesse, has no legitimate claim to those tax savings. Any tax benefits accruing to the investor would thus constitute "benefits conferred on the injured party from other sources" (Restatement (Second) of Torts § 920A(2) (1979)). It is true that a tax-shelter promoter functions in a sense as the but-for cause of deductions that the investor claims, and it is likewise true that tax considerations loom large in the typical investor's mind. But those facts do not make the plaintiff's tax benefits any less "collateral" in their origin. A doctor who provides medical services may be the but-for cause of his patient's claim to reimbursement from an insurance company, as well as of his patient's claim to a tax deduction for the medical expenses not so reimbursed. See Internal Revenue Code of 1954 (I.R.C.) § 213(a). In an action seeking recovery for medical malpractice, however, both types of benefits, being "benefits conferred on the injured party from other sources," would be deemed by the common law to emanate from "collateral sources" and hence would not serve to reduce the defendant's liability for damages.

B. The Measure Of Damages Under Sections 12(2) And 10(b) Is At Least As Favorable To The Plaintiff As The Common-Law Remedies For Securities Fraud

Private remedies under the federal securities laws were designed to supplement and enhance, not to diminish, the remedies available at common law. See *Bateman Eichler*, slip op. 8-11. In adopting its tax-offset

rule, the court of appeals has afforded the perpetrators of securities fraud a defense unknown to the common law and thus has given the federal remedial provisions an unduly narrow construction. That restrictive reading has scant support in the statutory language, and it is contrary to this Court's mandate that the securities laws be construed liberally to effectuate their remedial and deterrent purposes. *Herman & MacLean* v. *Huddleston*, 459 U.S. 375, 386-387 (1983); *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963). Far from "eschew[ing] rigid common-law barriers in construing the securities laws" (*Bateman Eichler*, slip op. 10), the court of appeals has erected novel barriers to a plaintiff's recovery, obstacles that would severely compromise the statutory objective of deterring fraud.

1. Section 12(2) of the 1933 Act, 15 U.S.C. 77*l*(2), provides that an investor who has been induced to purchase a security by a misleading prospectus or misleading oral communication

> may sue either at law or in equity in any court of competent jurisdiction to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon tender of such security * * *.

Section 12(2) alternatively permits a defrauded investor to sue "for damages if he no longer owns the security." Although the statute does not prescribe the mode of computing damages in the latter situation, courts and commentators have uniformly viewed Section 12(2)'s restitutionary formula as governing the computation of all monetary awards thereunder.[8]

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[8] See *Wigand* v. *Flo-Tek, Inc.*, 609 F.2d 1028, 1034-1036 (2d Cir. 1979); 11 H. Sowards, *The Federal Securities Act and the Trust Indenture Act of 1939*, § 904[5], at 9-26 (1985); 6 L. Loss, *Securities Regulation* 1221 (Supp. 1969). Contrary to the court of appeals' statement (Pet. App. A12 & n.11), it is irrelevant under Section 12(2) whether a plaintiff seeks "actual rescission" or "rescissionary damages," since Section 12(2)'s restitutionary formula is the same in either event.

By enacting Section 12(2), Congress made available to defrauded investors a statutory version of the common-law remedies of rescission and restitution. In so doing, moreover, Congress substantially liberalized the common-law cause of action. Section 12(2) eliminated the common-law requirement that an investor prove reliance on the fraudulent representations. It relaxed the strict privity requirements of common law by permitting suit against persons other than the immediate seller. And it significantly eased the plaintiff's burden of proof by shifting to the defendant the burden of showing due care. See *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 209 n.27, 212-214 (1976); *Deckert* v. *Independence Shares Corp.*, 311 U.S. 282, 288 (1940); H.R. Rep. 85, 73d Cong., 1st Sess. 23-24 (1933); L. Loss, *Fundamentals of Securities Regulation* 1024-1025 (1983).

Congress did not specify, either in the text of the statute or in its legislative history, what constitutes "income received * * * on" a security for purposes of Section 12(2). Courts and commentators alike, however, have interpreted those words to mean payments (whether in cash or in valuable property) generated directly by the security itself, such as dividends or distributions on stock, interest on bonds or on other evidences of indebtedness, royalty payments on mineral interests, or production payments on oil and gas leases.[9] This construction of the words "income received thereon" is consistent with the doctrine of common-law restitution, under which a rescinding purchaser, in order to recover his consideration, was required to restore to the seller only the original property and its "direct product." See page 10, *supra*.

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[9] See, *e.g.*, *Wigand* v. *Flo-Tek, Inc.*, 609 F.2d at 1037 n.9; *Mott* v. *Tri-Continental Financial Corp.*, 330 F.2d 468, 470 (2d Cir. 1964); *Johns Hopkins Univ.* v. *Hutton*, 297 F. Supp. 1165, 1231-1233 (D. Md. 1968), aff'd in part and rev'd in part, 422 F.2d 1124 (4th Cir. 1970), cert. denied, 416 U.S. 916 (1974); *Wall* v. *Wagner*, 125 F. Supp. 854, 858 (D. Neb. 1954), aff'd, 226 F.2d 868 (8th Cir. 1955). See also Kaminsky, *An Analysis of Securities Litigation Under Section 12(2) and How It Compares with Rule 10b-5*, 13 Hous. L.Rev. 231, 281 (1976).

This construction is likewise faithful to the common-sense meaning of the words "income received."

In holding that tax benefits claimed by an investor constitute "income received * * * on" his limited partnership investment, the court of appeals has done considerable violence to the English language. A limited partnership investment, of course, may generate "income" of various kinds—rent, royalties, interest and capital gains are typical examples—and a limited partner's distributive share of those items would obviously constitute "income received * * * on" his investment for purposes of Section 12(2). The tax benefits made available by such an investment, however, are not "income received thereon." Rather, those tax benefits take the form of deductions and credits that an investor may use to *offset* the income that he receives *from other sources*, or to reduce the tax that he would otherwise owe on income independently generated. Indeed, the court of appeals itself acknowledged that tax benefits received are not "a form of income in a strict accounting sense" (Pet. App. A11 (footnote omitted)).[10]

The notion that tax benefits are "income received" likewise does violence to Congress's remedial purposes in enacting Section 12(2). As we have shown (pages 13-14, *supra*), a defrauded investor's tax savings would not have reduced a defendant's liability to pay damages at common law. When Congress codified the common-law remedy of rescission and restitution in Section 12(2), it took

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[10] This Court's statements in *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837 (1975), are relevant in this respect. The court of appeals there had held that shares in certain housing projects constituted an "investment contract," reasoning that such shares incorporated "an expectation of income" owing to "the deductibility for tax purposes of the portion of the monthly rental charge applied to interest on the mortgage" (421 U.S. at 852). Reversing the court of appeals, this Court wrote: "We know of no basis in law for the view that the payment of interest, with its consequent deductibility for tax purposes, constitutes income or profits" (*ibid.*). The Court added that, "[e]ven if * * * tax deductions were considered profits, they would not be the type associated with a security investment since they do not result from the managerial efforts of others" (*id.* at 855 n.20).

steps to *liberalize* that cause of action so as to remove common-law barriers to recovery. See page 16, *supra*. Given that expansive purpose, Congress can scarcely have intended that Section 12(2) should be interpreted to erect a barrier to recovery that the common law itself did not recognize.

2. The court of appeals' tax-offset rule is equally inappropriate in computing damages under Section 10(b) of the 1934 Act, which the district court held would "independently support[]" (Pet. App. E16) a grant of relief here. Section 10(b) proscribes the use of manipulative and deceptive practices "in connection with the purchase or sale of any security" (15 U.S.C. 78j(b)). Recoveries under Section 10(b) and Rule 10b-5 in turn are subject to Section 28(a) of the 1934 Act, which states (15 U.S.C. 78bb(a)):

> The rights and remedies provided by this chapter shall be in addition to any and all other rights and remedies that may exist at law or in equity; but no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of.

Although the term "actual damages" is not defined in the securities laws, it had a well-established meaning when the Securities Exchange Act was enacted. The term "actual damages" was generally understood in 1934 to permit any appropriate recovery of nonspeculative, compensatory damages.[11] Section 28(a) has consistently been

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[11] In suits for patent infringement, for example, the statutory measure of damages had long been based on the "actual damages sustained" by the plaintiff. Act of July 4, 1836, ch. 357, § 14, 5 Stat. 123. Construing that term in *Birdsall* v. *Coolidge*, 93 U.S. 64, 70 (1876), this Court held that "[c]ompensatory damages and actual damages mean the same thing." Similarly, in interpreting a 1935 amendment to the Bankruptcy Act that used the term "actual damage" (Act of Aug. 27, 1935, ch. 774, § 77(b), 49 Stat. 914), this Court understood it to mean "compensatory damages," noting

interpreted in the same fashion. The statute has thus been held to permit recovery under traditional principles for determining compensatory damages, including the restitutionary measure familiar to the common law. See, *e.g.*, *Myzel* v. *Fields*, 386 F.2d 718, 740-742 (8th Cir. 1967), cert. denied, 390 U.S. 951 (1968); 5C A. Jacobs, *supra*, § 260.03[c]. In view of the limitation of a plaintiff's recovery to his "actual damages," Section 28(a) has been read to bar duplicative recoveries, as where a plaintiff asserts both federal and state claims arising out of the same course of conduct;[12] to preclude the award of punitive, as opposed to compensatory, damages;[13] and to preclude compensation for such non-economic losses as pain and suffering, emotional distress, and loss of image or prestige.[14]

In construing the statute to require reduction of a plaintiff's restitutionary award on account of his tax benefits, the court of appeals took an unduly narrow view of the concept of "actual damages" under Section 28(a). As this Court has recently emphasized, "[t]he Securities Act of 1933 and the [Securities Exchange] Act of 1934 'constitute interrelated components of the federal regulatory scheme governing transactions in securities.'" *Herman & MacLean* v. *Huddleston*, 459 U.S. at 380 (quoting *Ernst & Ernst* v. *Hochfelder*, 425 U.S. at 206). See *United States* v. *Naftalin*, 441 U.S. 768, 778 (1979). The remedial provisions of the two statutes should therefore be read in pari materia. See *Globus* v. *Law Research*

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that "[t]he ways compensatory damages may be proven are many." *Palmer* v. *Connecticut Ry. & Lighting Co.*, 311 U.S. 544, 560-561 (1941).

[12] See, *e.g.*, *Osofsky* v. *Zipf*, 645 F.2d 107, 111 (2d Cir. 1981); 3 L. Loss, *Securities Regulation* 1624 n.5 (2d ed. 1961).

[13] See, *e.g.*, *Osofsky* v. *Zipf*, 645 F.2d at 111; *Gould* v. *American-Hawaii S.S. Co.*, 535 F.2d 761, 781 (3d Cir. 1976).

[14] See *Osofsky* v. *Zipf*, 645 F.2d at 111; *Frigitemp Corp.* v. *Financial Dynamics Fund, Inc.*, 524 F.2d 275, 281 (2d Cir. 1975); *Weiss* v. *Hayden Stone, Inc.*, 340 F. Supp. 1074, 1075 (E.D.N.Y. 1972); L. Loss, *Fundamentals of Securities Regulation* 1140-1141 (1983).

Service, Inc., 418 F.2d 1276, 1286 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970); L. Loss, *Fundamentals of Securities Regulation* 1147 (1983). As we have shown above, a plaintiff who receives a restitutionary recovery under Section 12(2) of the 1933 Act may not have his award reduced by reference to his tax benefits, both because tax benefits do not constitute "income received" within the meaning of that Section and because tax benefits would not have affected his recovery at common law. Where a restitutionary recovery is appropriate under Section 28(a) for a violation of Section 10(b), therefore, the measure of damages should be at least as broad as that under the common law and under Section 12(2).

3. In holding that restitutionary recoveries under Sections 12(2) and 10(b) must be reduced by tax benefits, the court of appeals reasoned that a contrary result would "penalize defendants" by awarding the plaintiff an amount in excess of his "actual monetary loss" (Pet. App. A13). As we explain more fully below (pages 22-27), the court of appeals proceeded from an erroneous premise. The Internal Revenue Code incorporates detailed mechanisms for preventing undeserved windfalls to taxpayers in situations of this sort. The tax-offset rule is thus unnecessary.

Even if the court of appeals' premise were correct, however, its tax-offset rule would still be unjustifiable. The tax-offset rule confers a windfall on the wrongdoer by letting him keep the fruits of his fraud. In calculating damages under the securities laws, courts must take care to avoid unjustly enriching defendants. The remedy of rescission and restitution at common law permitted a plaintiff to recover an amount in excess of his actual economic loss where necessary to prevent the wrongdoer's unjust enrichment; as between the wrongdoer and his victim, any doubt concerning entitlement to the benefits of a rescinded transaction was resolved in favor of the latter. See pages 11-12, *supra*. This Court has recognized that a measure of damages that prevents defendants from retaining their ill-gotten gains is fully appropriate under

the federal securities laws. *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 155 (1972). Courts measuring damages in securities-fraud cases have regularly looked to the defendant's profit rather than to the plaintiff's loss where necessary to prevent unjust enrichment, correctly reasoning that "[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them." *Janigan* v. *Taylor*, 344 F.2d 781, 786 (1st Cir.), cert. denied, 382 U.S. 879 (1965). In short, "[t]he damages ceiling imposed by [Section] 28(a) in terms of 'actual damages on account of the act complained of' does not foreclose a windfall recovery based on the defendant's benefit rather than the plaintiff's loss." L. Loss, *Fundamentals of Securities Regulation* 1134 (1983).[15]

These equitable principles show the error of the court of appeals' tax-offset rule. If there should remain, at the end of the day, any permanent tax benefits stemming from the rescinded investment, those benefits will have come at the expense of the public fisc. If those benefits are used to reduce the plaintiff's securities-fraud recovery, the effect is to transfer this species of publicly-funded largesse, dollar-for-dollar, from the plaintiff to the defendant. Such a result would produce unjust enrichment because, as between the plaintiff and the defendant who defrauded him, the plaintiff is plainly more equitably situated to retain the benefits that Congress has provided. The investor is not only the victim rather than the wrongdoer, but he is the party upon whom Congress conferred the tax benefits in the first place. If there is to be a windfall, the deterrent purposes of private actions under the

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[15] Accord, *e.g.*, *Hackbart* v. *Holmes*, 675 F.2d 1114, 1122 (10th Cir. 1982) ("[p]reventing unjust enrichment is a well-recognized exception to the rule limiting damages to the out-of-pocket loss"); *Nelson* v. *Serwold*, 576 F.2d 1332, 1338 (9th Cir. 1978) ("recent trend looks to defendant's profits, rather than to plaintiff's losses, in measuring damages"). See also *Zeller* v. *Bogue Electric Manufacturing Corp.*, 476 F.2d 795, 802 (2d Cir.), cert. denied, 414 U.S. 908 (1973); 5C A. Jacobs, *supra*, § 260.03[a], at 11-18; Thompson, *supra*, 37 Vand. L.R. at 372, 378-79.

securities laws mandate that it come to rest where Congress originally put it—with the plaintiff and not with the defendant.[16]

C. The Tax Laws, Without The Aid Of The Court Of Appeals' Tax-Offset Rule, Will Operate To Ensure That A Rescinding Purchaser Receives No Undeserved Windfall

Besides interpreting erroneously the rules governing damages in securities cases, the court of appeals' decision is wrong as a matter of tax law. In appraising a defrauded plaintiff's overall tax benefits, it is necessary to consider, not only the tax benefits previously claimed, but also the tax consequences of the fraud recovery itself. Where, as here, the award will be subject to tax, it is obviously improper to base that award on an after-tax estimate of the plaintiff's loss. In *Hanover Shoe, Inc.* v. *United Shoe Machinery Corp.*, 392 U.S. 481 (1968), a case involving the computation of antitrust damages, this Court held that a plaintiff's award for lost profits must be based on what its pre-tax profits would have been absent the antitrust violation, given the fact that the antitrust award would itself be taxable in the plaintiff's hands. To reduce the plaintiff's damages by the taxes that would have been payable on the lost profits, the Court held, "would be to apply a double deduction for taxation" (392 U.S. at 503). Compare *L.P. Larson Co.* v. *Wm. Wrigley Co.*, 277 U.S. 97, 100 (1928) (award for lost profits based on pre-tax earnings where award is taxable), with *Norfolk & W. Ry. v. Liepelt*, 444 U.S. 490, 496 (1980) (award for lost income based on after-tax earn-

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[16] The conclusion that tax savings should not offset the defrauding seller's duty to refund the buyer's consideration under Section 12(2) also dictates that tax savings should not affect the seller's duty to pay "interest thereon" (15 U.S.C. 77*l*(2)). The court of appeals below thus erred (Pet. App. A19-A21) in computing petitioners' prejudgment interest. Although the Ninth Circuit has rejected the tax-offset rule in other respects (*e.g.*, *Burgess* v. *Premier Corp.*, 727 F.2d 826, 837-838 (1984)), it likewise has erred in holding that a plaintiff's tax savings may offset his prejudgment interest (*id.* at 838).

ings where award is not taxable), and *Jones & Laughlin Steel Corp.* v. *Pfeifer*, 462 U.S. 523, 534 (1983) (same).

The court of appeals recognized (Pet. App. A22) that the application of its tax-offset theory, without more, would have imposed a double burden on petitioners by reducing, with reference to past tax savings, a damages recovery that would itself be taxed. In apprehending that fact, the Eighth Circuit identified an egregious error committed by other courts that have considered this question.[17] Given the chance to avoid one error, however, the court of appeals proceeded to commit two. The court declined to follow this Court's reasoning in *Hanover Shoe*, under which a taxable award of damages should be based on the plaintiff's *pre-tax* loss. Instead, the court of appeals persisted in applying its tax-offset rule, basing its tentative award of damages on petitioners' *after-tax* loss, and then, in order to reflect the award's taxability (Pet. App. A22), arbitrarily doubled the amount previously computed.

As a matter of tax law, not to mention common sense, the court of appeals' approach is seriously flawed. Its approach is inherently arbitrary, since it is based (Pet. App. A22) on unsubstantiated assumptions about petitioners' tax brackets and about how their awards will be taxed. The court's two errors, while seemingly symmetrical conceptually, do not cancel each other out in practical effect, but rather yield awards that are small fractions of what they would have been if the tax consequences were ignored altogether. See pages 6-7 note 1, *supra*. Most fundamentally, the Internal Revenue Code incorporates sophisticated mechanisms for preventing undeserved windfalls to taxpayers in circumstances like those here. Those mechanisms, unaided by the court of appeals' tinkering, will achieve the result that the court of appeals desired, and will do so in the manner that Congress has ordained.

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[17] See *Salcer* v. *Envicon Equities Corp.*, 744 F.2d 935 (2d Cir. 1984), petition for cert. pending, No. 84-1447; *Freschi* v. *Grand Coal Venture*, 767 F.2d 1041 (2d Cir. 1985), petition for cert. pending, No. 85-377.

1. The anticipated "tax benefits" stemming from a real estate tax shelter principally include losses that pass through from the partnership to the partners and become available as deductions against otherwise-taxable income on the partner's individual return. Such losses also serve to reduce, dollar-for-dollar, the partner's cost, or tax "basis," of his investment. A real estate tax shelter typically employs leveraged financing, permitting investors to secure current deductions in excess of their cash outlay. These deductions are counterbalanced in the year the investment is sold by the requirement that the investor include in his "amount realized," for purposes of computing his taxable gain, the amount of debt from which he is thereby discharged. *Commissioner* v. *Tufts*, 461 U.S. 300 (1983); *Crane* v. *Commissioner*, 331 U.S. 1 (1947). Generally speaking, a partner's gain on disposition of his investment will be taxable at preferential capital gains rates. However, some of the tax benefits generated during a tax shelter's early years—such as accelerated depreciation and investment tax credits—are subject to "recapture" as ordinary income upon that disposition. See, *e.g.*, I.R.C. §§ 47, 48(q), 1245, 1250; *Commissioner* v. *Tufts*, 461 U.S. at 303 n.2. In sum, tax shelters generally provide a form of tax deferral and, in certain circumstances, conversion of ordinary income into capital gain, rather than a means of permanent tax avoidance. See Ginsburg, *The Leaky Tax Shelter*, 53 Taxes 719 (1978).

2. If an investor who has successfully claimed such tax-shelter benefits subsequently obtains a recovery in a securities-fraud suit, the effect of that recovery under the Internal Revenue Code will be to offset, in whole or in part, the tax benefits previously received. The precise manner in which this offset will be accomplished depends on several variables—whether the investor's tax returns have been audited by the IRS, what steps he has previously taken with respect to his investment, and what kind of recovery he obtains in the securities action. Under any scenario, however, the tax laws will require the partner

to settle his accounts with the IRS—once all the facts surrounding his unhappy investment are finally determined —so as to eliminate the possibility of his garnering any undeserved windfall.

If the defrauded partner wins relief in the nature of rescission, some if not all of his recovery will probably be taxed to him as ordinary income under the "tax benefit rule." As this Court recently observed, the tax benefit rule operates to "cancel out an earlier deduction" when a subsequent event is "fundamentally inconsistent with the premise on which the deduction was initially based." *Hillsboro Nat'l Bank* v. *Commissioner*, 460 U.S. 370, 383 (1983) (original quotation marks and footnote omitted). See, *e.g.*, *Unvert* v. *Commissioner*, 656 F.2d 483 (9th Cir. 1981), cert. denied, 456 U.S. 961 (1982) (requiring tax-shelter investor to recognize income on recovery of funds from promoter, where amounts had been deducted in previous tax year). Alternatively, if the defrauded partner wins out-of-pocket damages, the damage award generally will serve to reduce the basis of his partnership interest. If he has already disposed of his interest, or if he has reduced his basis to zero by previously-claimed deductions, the entire damage award will represent taxable income when received. Such an award might be taxed, in whole or in part, as ordinary income under the tax benefit rule or under the Code's various "recapture" provisions. The manner in which the recovery will be taxed may also depend on the taxpayer's earlier treatment of his investment for tax purposes, *e.g.*, on whether he had previously deducted it in full as a worthless security or as a theft loss. See I.R.C. § 165(c)(3), (e) and (g); *Boehm* v. *Commissioner*, 146 F.2d 553 (2d Cir.), aff'd, 326 U.S. 287 (1945). Any portion of the recovery not taxed as ordinary income would be taxed at capital gains rates. See *Raytheon Production Corp.* v. *Commissioner*, 144 F.2d 110 (1st Cir.), cert. denied, 323 U.S. 779 (1944).

As the court of appeals perceived, the mechanisms described above are unlikely in any case to eliminate the economic value of tax benefits previously enjoyed. A deduction in year one, coupled with the inclusion in income

of an identical amount in year ten, will rarely yield precisely offsetting economic consequences, owing to the time value of money, possible changes in tax rates, and intervening changes in the investor's tax bracket. See *Alice Phelan Sullivan Corp.* v. *United States*, 381 F.2d 399 (Ct. Cl. 1967). As this Court has explained, however, the purpose of the tax benefit rule is not to achieve mathematical perfection but "to achieve rough transactional parity in tax" (*Hillsboro Nat'l Bank*, 460 U.S. at 383). It would surely be more accurate, from a conceptual point of view, not to tax a restitutionary award upon receipt, but instead to reopen the taxpayer's earlier years and disallow all deductions and credits predicated on his ownership of the now-rescinded investment. As this Court noted in *Hanover Shoe*, however, "the statute of limitations frequently will bar the Commissioner from recomputing for earlier years," and such recomputations in any event would be "immensely difficult or impossible when a long period has intervened" (392 U.S. at 503). For these reasons, and because of the well-established "annual accounting principle," the IRS "in practice * * * has taxed recoveries for tortious deprivation of profits at the time the recoveries are made, not by reopening the earlier years." *Ibid.* (citing *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426 (1955)). While this result may lack conceptual purity in the eyes of some, and while it may often permit an injured plaintiff ultimately to recover an amount somewhat in excess of his actual economic loss, Congress has determined, and this Court has agreed, that "the rough result of not taking account of taxes for the year of injury, but then taxing [the] recovery when received, seems the most satisfactory outcome" (*Hanover Shoe*, 392 U.S. at 503). The court of appeals had no license to opt for a different calculus, even if equity supported that choice, which it does not.

3. The above discussion is not intended as an exhaustive catalog of tax consequences, which can be extremely complex and take years to resolve. The point is simply that the Internal Revenue Code, left to its own devices, will prevent the plaintiff from receiving any "undeserved

windfall" (*Salcer*, 744 F.2d at 942). If a defendant has defrauded a plaintiff, the damages should be measured by the plaintiff's loss *on his investment*. The tax ramifications of the award are a matter between the plaintiff and the IRS. Once the securities lawsuit is over, and the relevant facts are finally determined, those ramifications will be sorted out, on a case-by-case basis, under well-established tax principles. If, when the dust has settled, the plaintiff emerges with net tax benefits, and if that is considered a "windfall" to him, the windfall is not "undeserved." It is not undeserved because it reflects the customary operation of tax rules that Congress has designed specifically to deal with the situation at hand. And it is not undeserved because the plaintiff in any event is the victim rather than the perpetrator of fraud.

D. The Tax-Offset Rule Would Impede The Administration Of The Federal Securities And Tax Laws

In insisting upon the offset of previously-claimed tax benefits, the court of appeals has opted for an impractical and inequitable result that would have a significant adverse impact on administration of the federal securities and tax laws. Just last Term, this Court emphasized once again the important deterrent value of private actions, observing that they "provide a most effective weapon in the enforcement of the securities laws." *Bateman Eichler*, *supra*, slip op. 10 (original quotation marks omitted). By improperly reducing—and often, as was true in *Salcer*, eliminating entirely—the damages recoverable by plaintiffs who have been defrauded in tax-shelter schemes, the tax-offset rule would necessarily lessen the incentives for promoters to comply with the securities laws by permitting wrongdoers to retain the fruits of their fraud.

The tax-offset rule is particularly noxious because the perimeters of its application are so unclear. The court of appeals purported to restrict its applicability to "the special case of a tax shelter investment" (Pet. App. A8), but we see no principled basis for that limitation, even if it were possible to say which tax-preferred investments

are "shelters" and which are not. Although tax advantages are particularly prominent in the case of real estate partnerships like that involved here, tax considerations play a significant role in countless investment decisions, from the purchase of municipal bonds and of interests in oil wells to investment in IRA accounts and "all-savers certificates." People may be motivated to buy common stocks rather than bonds because of the annual dividend exclusion (I.R.C. § 116); they may be motivated to buy low-yielding growth stocks rather than high-yielding blue chips in the hope of having their profits taxed as long-term capital gain rather than ordinary dividend income; and they may be motivated to buy shares of public utilities in the hope of receiving return-of-capital distributions (I.R.C. § 301(c)(2)) or avoiding current taxation on "qualified reinvested dividends" (I.R.C. § 305(e)). While it had previously seemed settled that a plaintiff's tax savings are irrelevant in computing damages where such investments are concerned,[18] the court of appeals' analysis would make the outcome most unclear.

Besides being applicable to routine securities investments, the tax-offset rule is expandable to routine tax deductions. The Eighth Circuit below reduced petitioners' damages on account of tax benefits passed through to them by the limited partnership itself. In *Freschi* v. *Grand Coal Venture*, 767 F.2d 1041 (1985), petition for cert. pending, No. 85-377, however, the Second Circuit reduced a plaintiff's damages because he had previously deducted his worthless tax-shelter investment as a "theft loss." See I.R.C. § 165(e); 767 F.2d at 1051. In extending the tax-offset rule to deductions claimed by taxpayers for losses suffered on disposition of investment assets, the Second Circuit's approach would affect the computation

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[18] See, *e.g.*, *Wiesenberger* v. *W.E. Hutton & Co.*, 35 F.R.D. 556, 558 (S.D.N.Y. 1964) (action for rescission of participation in oil venture); *Cooper* v. *Hallgarten & Co.*, 34 F.R.D. 482, 486 (S.D.N.Y. 1964) (action for rescission of investment in oil and gas leasehold). Cf. *Smolowe* v. *Delendo Corp.*, 136 F.2d 231, 238 (2d Cir.), cert. denied, 320 U.S. 751 (1943) (liability for "short-swing" trading profits under 15 U.S.C. 78p(b)).

of damages in virtually all securities transactions. The injustice of that approach is manifest: the promoter of a fraudulent investment is permitted to pocket the proceeds of his fraud because of a tax loss that his very fraud has generated. It had once seemed clear that tax savings of this sort are irrelevant in computing damages. See, *e.g.*, *G & R Corp.* v. *American Security & Trust Co.*, 523 F.2d 1164, 1176 (D.C. Cir. 1975) (refusing to allow offset of tax savings stemming from bad-debt deduction). But the court of appeals' analysis, particularly in light of the Second Circuit's adaptation of it,[19] is of such uncertain dimensions as to place the outcome in doubt.

From a tax perspective, the decision below is equally troubling. It will often happen, at the commencement of a securities action, that the tax returns on which the plaintiff claimed his deductions will be under audit by the IRS. In such circumstances, obviously, the plaintiff's "tax benefits" will be wholly speculative, and any effort to offset the damage award thereby will lapse into a tailspin of circular reasoning.[20] Most significantly, the court

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[19] The Second Circuit's approach in *Freschi* is equally pernicious in applying the tax-offset rule in computing "out-of-pocket" damages, which are based on the difference between the price paid for the security and its actual value at that time. The tax-offset rule is plainly at odds with the out-of-pocket measure of damages, under which the plaintiff *keeps* the security and is entitled to retain benefits stemming directly or indirectly from its ownership. See 5C A. Jacobs, *supra*, §§ 260.02 & n.3, at 11-13, 260.03[c][ii], at 11-29.

[20] It is no answer to suggest, as did the panel opinion below, that "[e]vidence of the audit and expert opinions as to its likely result" should be introduced at trial, with "[t]he jury [being] entitled to determine whether and to what extent there would be a disallowance of deductions" (Pet. App. D27). The prospect of juries guessing about the outcome of complicated tax audits is altogether impractical. Nor is it any answer to demand, as did the Second Circuit in *Salcer*, that the IRS speed up its audit procedures "rather than attempt to place the issue in limbo indefinitely" (744 F.2d at 943). The difficulties attending audits of tax shelters, which may have thousands of investors nationwide, are formidable, and recently prompted Congress to enact detailed remedial legislation. See Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248,

of appeals' tax-offset rule "make[s] the government the banker for fraudulent tax shelter activity." *Burgess* v. *Premier Corp.*, 727 F.2d 826, 838 (9th Cir. 1984). There is no reason why a defendant's liability for his fraud should be diminished at the expense of his victims, or at the expense of the Nation's taxpayers generally.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

CHARLES FRIED
Solicitor General

ROGER M. OLSEN
Acting Assistant Attorney General

LAWRENCE G. WALLACE
Deputy Solicitor General

ALBERT G. LAUBER, JR.
Assistant to the Solicitor General

DANIEL L. GOELZER
General Counsel

ANN BELANGER DURNEY
TERESA E. MCLAUGHLIN
Attorneys

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

RICHARD A. KIRBY
Assistant General Counsel

MARTHA H. MCNEELY
CATHERINE T. DIXON
Attorneys
Securities and Exchange Commission

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Tit. IV, § 402(a), 96 Stat. 648-669 (enacting I.R.C. §§ 6221-6232). We have been informed by the IRS that more than 30,000 tax shelter cases are currently pending in the Tax Court, representing almost 40% of that court's docket.

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